CARDEROCK
CAPITAL® MANAGEMENT, INC.

January 9, 2023

After 2021 ended the year with a bang, with stocks reaching their all-time highs on the very last day of the year, it's an understatement to say that 2022 went out with a whimper. The S&P 500 posted a (-18%) return for the year while Carderock stocks were down (-23%), with a balanced 55%-35%-10% (Stocks-Bonds-Cash) portfolio down approximately (-15%). At this stage, we are focused on how disappointing results have presented long-term investment opportunities not seen in years.

With a long history of investing through bull and bear markets, we are acutely aware that major swings such as these are not uncommon…in stocks. Prior to 2022, there had been only four years since 1928 where Bonds and Stocks both posted negative returns for the year. Given that last year's anomaly is explained by the Federal Reserve's swift policy reversal of hiking rates from zero, we're somewhat relieved to consider a reprint in 2023 unlikely.

Looking ahead, we expect 2023 to see a return to the virtues of participating in a balanced portfolio as the Fed nears the end of its tightening cycle. Though we are positioned defensively to start the year, we see more positive developments than what is currently expected among the general investment community.

Our View for 2023

The Economy

Inflation declines as supply chains fully normalize, corporations offload excess inventory through discounts and rents fall.
Commodities Deflation in oil, gas, timber and wheat since the onset of the Ukraine war will boost household incomes and construction activity.
Labor markets and wages remain robust as Baby Boomer retirements and declining immigration have led to a shortage of workers.
Capital Investment in battery technology, alternative energy and automation accelerate as Europe weans itself from Russian gas and corporations substitute capital equipment for labor.
A Soft (Slower Growth) vs. Hard Landing (Recession) depends on Federal Reserve policy, while typical preconditions leading to a significant downturn are non-existent (excess corporate investment, household debt, oil spikes).

Stocks

Quality Growth Stocks fare better than cyclical alternatives amidst slower growth and an interest rate hiking cycle near its peak.
Earnings Growth will track a tepid economic environment but decline less than what is anticipated by current stock prices.
Profit Margins continue to decline albeit from record levels.
Sector Divergence 2022's barbell performance between Energy (up 47%) and Communications (down 41%) has opened opportunities to redeploy cash in 2023 across many down sectors, setting up a stock picker's market.

Fixed Income

Interest Rates peak in 2023 as inflation data continues to come in soft and the Federal Reserve shifts to neutral from overdrive.

Carderock's Low Average Maturity of roughly 2.5 years in our fixed income portfolios will allow us to take advantage of higher yields in 2023 as maturities occur.

Final Thoughts:

Positive developments on inflation over the past several months have boosted Stocks off their 2022 lows. With a defensive 35% cash target in our equity portfolios to start the year, we are closely monitoring both the Federal Reserve's reactions to economic data and earnings reports of our Quality Growth stocks for signs of a sustainably positive long-term trend. Good news is coming- it's strictly a question of when.

We see 2023 as a year of normalization across stock and bond markets, as much of the post-pandemic speculative activity fades away and investors shift their focus back to highly profitable and quality businesses. With enough patience, you will be rewarded for sticking to the fundamentals and eschewing unsustainable fads.

As always, feel free to give us a call to review your investment progress or ask any questions you may have.

Warmest Regards,

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In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Random Gleanings

"Today, core inflation is at its highest levels in decades, requiring the Fed to aggressively raise interest rates. But there also is still the hope that much of the inflation was caused by pandemic distortions in the economy that are in the process of abating, or that can be reined in by the Fed without leading to a significant rise in unemployment. October's soft Consumer Price Index inflation report provided a data point in favor of this argument, which is why markets responded so positively. Recession worriers pointing to the inverted yield curve have several decades of recent history in their favor. But nothing about this economic cycle has been typical." Conor Sen, *"Bond Markets Inverted Yield Curve Has Something for Everyone"*, **Bloomberg,** November 21st.

"It was a terrible year for both US stocks and bonds. The Fed signaled last year that rising inflation needed higher interest rates and an end to bond buying support of markets. The S&P 500 index is down 20 per cent from the start of the year; long-term bonds have had their worst year since the 19th century; and the long-established 60/40 investment strategy was hit with its worst year since the 1930s." Keith Fray, Steven Barnard, Matthew Brayman and Justine Williams, *"War, inflation and tumbling markets: the year in 11 charts"*, **Financial Times,** December 29th.

"The next US recession is likely to be a mild or average one, in contrast to the last two severe contractions. There are no obvious private sector imbalances in the US, excess savings that have accumulated over the course of the pandemic argue for a comparatively mild rise in the unemployment rate, and the ongoing scarcity of labor suggests business may be reluctant to shed as many jobs during a recession as they otherwise might be inclined to do." Jonathan LaBerge, Gabriel Di Lullo, Peter Berezin, *"Outlook 2023: How Much More Pain?"*, **The Bank Credit Analyst,** December.

"Despite Fed chair Jay Powell's and other top officials' insistence that a "soft or softish landing" is possible given the historically tight labor market, the bulk of the economists polled see a period of pain on the horizon. Of the 45 economists surveyed between December 2 and December 5, 85% project that the National Bureau of Economic Research — the arbiter of when recessions begin and end — will declare one by next year. Most economists expect a short-lived contraction— with GDP growth of 1% by year-end despite unemployment rising to 5.5%." Colby Smith, Caitlin Gilbert, *"US unemployment rate set to surpass 5.5%, economist predict"*, **Financial Times,** December 7th.

"I think [former Federal Reserve chair] Paul Volcker, was right to stop tightening monetary policy with inflation at 4%. By contrast, Alan Greenspan [his successor], was wrong to say we should push it as far down as 2%. You really do want to have your fiscal policy ducks in a row to deliver a major stimulus in a recession by cutting rates by five percentage points or so." Martin Sandbu, *"Brad Delong: 'The US is now an anti-globalisation outlier'"*, **Financial Times**, November 24th.

"During the Pandemic, investors desperate for growth and yield amid historically low interest rates, prioritized the promise of growth over proven earnings until the shares of companies with big dreams and equally large losses soared to dizzying heights. Those days are over. Inflation and rising central bank rates have changed the financial calculus. When investors can earn measurable returns from bank deposits and top-rated bonds, speculative investments wane." Brooke Masters, *"Three ways Big Tech got it wrong"*, **Financial Times**, December 28th.

"Global stocks and bonds will register losses of more than $30 trillion for 2022 after inflation, interest rate rises and the war in Ukraine triggered the heaviest losses in asset markets since the global financial crisis. The market value of companies traded across all global stock exchanges tumbled by $25 trillion, according to Bloomberg, while the data provider's Multiverse index, which tracks global government and corporate debt, is down almost 16 per cent or $9.6 trillion in market value terms, according to provisional calculations at Thursday's market close." Tommy Stubbington, Adam Samson and Kate Duguid, "*Stock and Bond Markets Shed more than $30 Trillion in Brutal 2022*", **Financial Times**, December 30th.

"Junius Spencer Morgan, J.P. Morgan's father, warned his titan-to-be son against becoming a bear on America, advice that Standard & Poor's perhaps wished it had followed in 2011 when it marked down the Treasury's triple-A rating to double-A-plus. The downgrade earned S&P splashy headlines and some long-lingering, unwanted regulatory attention from the aggrieved, split-rated government. However, while the double-A-plus rating stands, Mr. Market showed how little it mattered. Now, a decade after S&P stuck its neck out, inflation has returned, the cost of borrowing has soared and the rate of federal borrowing has accelerated. Barring remedial action, debt-service costs would one day devour the GDP." James Grant, *"Ponzi by the Potomac*", **Grant's Interest Rate Observer**, December 23rd.